RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

SINCE1958

PO Box 1759, La Jolla, California 92038 — 17 Letters Per Year - $250 Annually

LETTER 1325

October 10, 2001

September 21, DJIA 8238.60; PTI 5285; A-D Ratio -5.92
September 28, DJIA 8847.56; PTI 5295; A-D Ratio -4.37
October 5, DJIA 9119.77; PTI 5311; A-D Ratio -3.88
Dow yield: 1.97% Dow p/e: 23.13
Gold 50-day MA: 280.60

THE PICTURE: Question: Russell, do you think we've seen the end of the bear market?

Answer: No primary bear market has ever ended with the kind of valuations we are seeing now. Bear markets end with stocks at great values. For instance, in 1974 when the bear market ended, the S&P was selling at 7 times earnings. Again, in 1982 when that bear market ended, the S&P was selling at 8 times earnings. Right now, depending on who you believe the S&P is selling at anywhere from 26 to 36 times earnings.

Question: What about earnings?

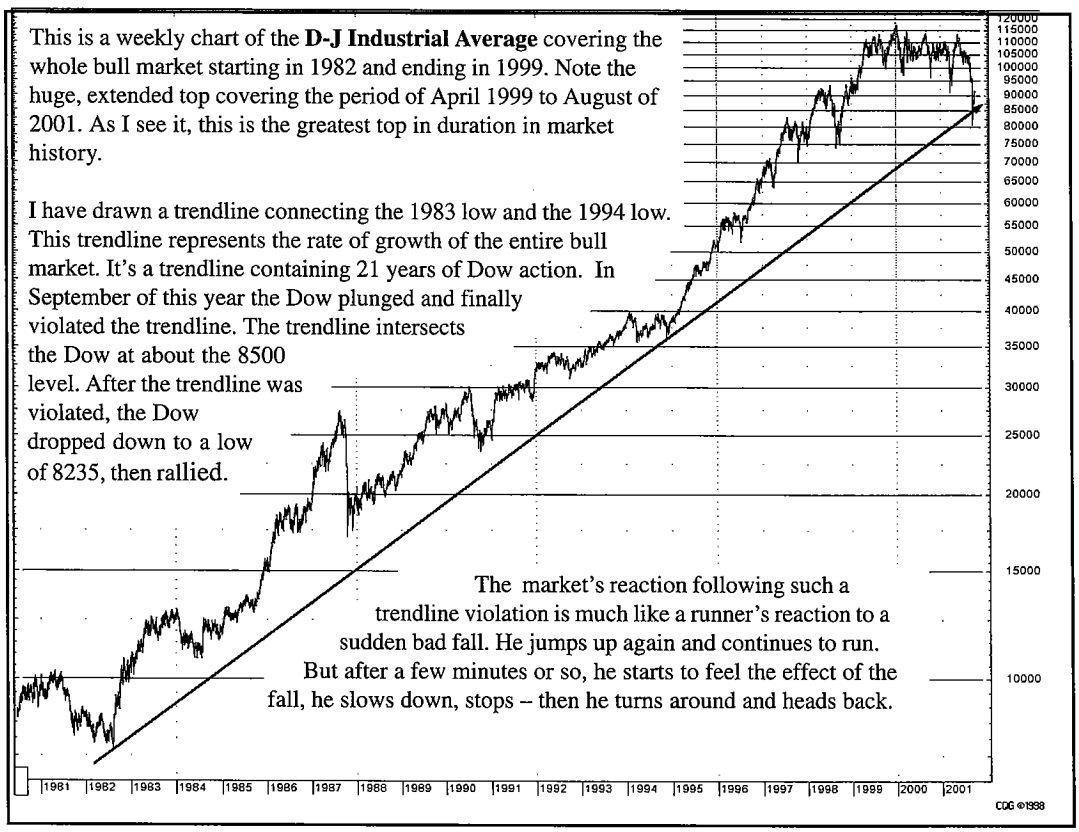
Answer: Recently, the *Wall Street Journal* went through a long list of corporate earnings, and the true S&P price/earnings figure they came up with was 36 times earnings.

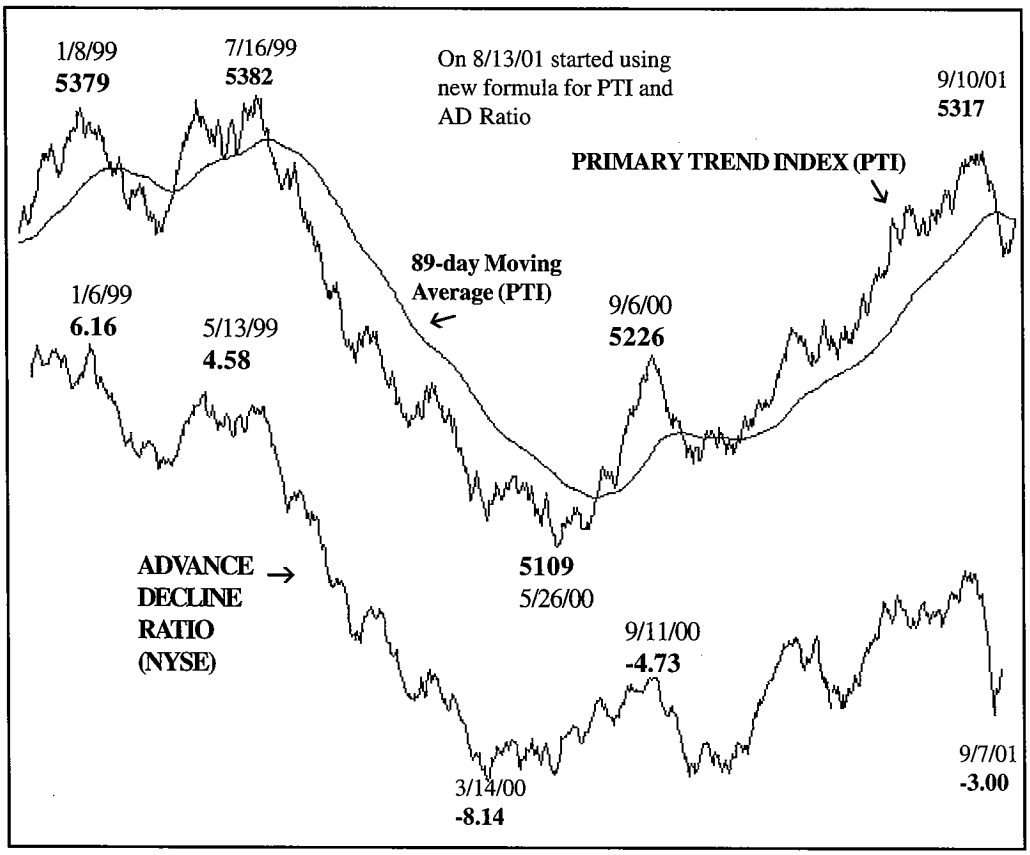
Question: Why all the subterfuge and dishonesty in corporate earnings?

Answer: Basically, it's the crash in so many stocks and mainly the tech stocks that pushed stocks toward generating dishonest earnings. The crazy emphasis on quarterly earnings had accountants working overtime and via manipulation and "creating accounting" they managed to come up (again and again) with earnings "up a penny." It got to be a joke, but since "up a penny" is what investors wanted to hear, it also became accepted.

In a bear market all the dirty water seeps out from under the closet, and now we know how dishonest those "up a penny" earnings were.

One of the worst offenders was CNBC, which never even attempted to look through these "dirty" earnings. The phony


This is a weekly chart of the D-J Industrial Average covering the whole bull market starting in 1982 and ending in 1999. Note the huge, extended top covering the period of April 1999 to August of 2001. As I see it, this is the greatest top in duration in market history.
I have drawn a trendline connecting the 1983 low and the 1994 low. This trendline represents the rate of growth of the entire bull market. It's a trendline containing 21 years of Dow action. In September of this year the Dow plunged and finally violated the trendline. The trendline intersects the Dow at about the 8500 level. After the trendline was violated, the Dow dropped down to a low of 8235, then rallied.
The market's reaction following such a trendline violation is much like a runner's reaction to a sudden bad fall. He jumps up again and continues to run. But after a few minutes or so, he starts to feel the effect of the fall, he slows down, stops – then he turns around and heads back.
120000
115000
110000
105000
100000
95000
90000
85000
80000
75000
70000
65000
60000
55000
50000
45000
40000
35000
30000
25000
20000
15000
10000
1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001
COG ©1998



earnings were simply reported as if they were honest. And the public ate it up – until the bear market systematically collapsed the stocks. Of course, Wall Street's analysts also participated in the dishonest game.

David Dreman, chairman of Dreman Value Management, wrote a fine column about these deceitful earnings. The article, entitled "Fantasy Earnings" appeared in the October 1 issue of *Forbes* magazine.

Dreman writes that a big reason for the Nasdaq bubble's collapse "is that much of this inflated valuation was based on accounting smoke and mirrors." But the Association for Investment Management and Research, which sets ethical standards for analysts, doesn't seem to care. Their oversights and laziness when everything is going great is bad enough. For AIMR to continue to shrug off fairy-tale accounting is downright inexcusable.

"Fuzzy figures, variously called operating earnings or pro forma earnings, are completely inconsistent from company to company. Generally accepted accounting principles are left in the garbage when companies hype earnings by excluding all manner of costs as one-time events – ranging from payroll expenses to layoff costs to inventory write-downs. According to the *WSJ*, some 300 companies in the S&P 500 already have played this game in 2001.

"The grand prize for pro forma fluffery earnings is a tie between Amazon and Yahoo, both masters at gaming the system by clever use of goodwill amortization, restructuring charges, stock-based compensation and on and on.

"It takes major talent to make $15 to $25 million a year, as the top analysts do, and blatantly disregard the welfare of investing clients. The Henry Blodgets and Mary Meekers are to stock picking what witch doctors are to brain surgery. Hazardous to your portfolio's health. What can you do about this accounting scourge? Until such shenanigans are sharply restricted, beware of any company that reports nice pro forma or operating earnings."

Question: Russell, do you think the market will stabilize and set off a major advance once the shock of the New York disaster wears off?

Answer: The Twin Towers disaster struck during a primary bear market. This creates a different situation than if the disaster had occurred during a bull market.

Although the reaction to the disaster may have been more severe because it occurred during a bear market, the paradox is that the disaster might end up extending the bear market. The reason is that the disaster will foster a lot of extra work entailed with rebuilding New York and making the rest of the nation more secure.

In fact, we might even see a mini-bull market materialize out of the New York disaster. But the mini-bull market will merely result in the bear market being extended, much as the 1966 to 1974 bear market was extended. In the end, the bear

market will continue until selling by investors is exhausted and great values finally appear in stocks.

Question: What do you think is the most dangerous phenomenon connected with this bear market?

Answer: If I had to pick one area of danger, I'd pick debt. I've written extensively about debt – suffice it to say that both corporations and individuals are dealing with the highest debt levels in history. This probably has to do with the unreal levels of confidence that we witnessed at or even past the bull market top. Nobody thought that anything lay ahead but blue skies and golden dreams.

As stocks declined and as the wealth effect turned around and operated in reverse, people felt poorer and they were poorer. The same thing occurred at the corporate sector as stocks collapsed but debt remained at the same high levels.

As interest rates were driven down, many people refinanced their homes and then spent the money, thus increasing their indebtedness. And many corporations sold bonds, often to buy back their own stocks, and in this way they stupidly increased their indebtedness.

In short, debt is fine and justified in a bull market. In a bear market, debt becomes a dangerous burden.

Question: How does this bear market compare with other primary bear markets?

Answer: The 1929-32 bear market took the Dow down 89%. The 1937-42 bear market took the Dow down 53%. The 1946 to 1949 bear market took the Dow down 24%. The 1966 to 1974 bear market took the Dow down 45%.

The bear market so far has taken the Dow down 29% although the Nasdaq is down 77%. And the broad Wilshire 5000 is down almost 40%.

Question: I note that you don't recommend shorts, even in a bear market. Yet a lot of money has been made on the short side. Why are you so resistant to shorting the market or shorting DIA or SPY or QQQ?

Answer: My objection to subscribers shorting the market is based on experience. For every subscriber who makes money in shorts, five lose. That's been my experience, sorry. First, when you short a stock you are playing against time. As dividends are declared, you must pay them out (of course that's not true if you short an ETF).

Shorting goes against most people's nature. People want to be bullish, and they like being bullish. When you put out shorts, you're waiting for bad news, searching for bad news, hungering for disaster. When you buy a stock and it's a value, you can sit with that stock and collect the dividends. It's a different mind-set.

Also, shorting entails exquisite timing. If you short even a few days early, you're liable to be squeezed by rising prices. But the biggest problem with shorting is that you are liable to be caught in a violent rally. There's no squeeze like a short squeeze, believe me. The losses on the short side are open-ended, since there's no telling how high a stock can rise.

When a stock that you've bought declines, theoretically the stock becomes an increasing value as it declines. But on the short side when your stock is rising in a short squeeze, you really have no reason to stay with your trade. It's going against you, and well, why stay with the trade and continue to lose money?

Question: Why are you so certain that aside from all periodic upward corrections and rallies, the market is heading a lot lower?

Answer: Between 1982 and 2000 the market went from extreme undervaluation to extreme overvaluation. In September 1999 a bear market was signaled, even though following the signal the Dow advanced to a new unconfirmed high.

Bear markets exist to correct the excesses of the preceding bull market. Great bull markets tend to produce great bear markets. Stocks tend to revolve above and below their mean valuations. The further above the mean, the more "stretched" the stock or the stock average.

The average price/earnings ratio for the S&P over the years has been 14.5. Nobody is certain what the P/E for the S&P is at present because of all the dishonest accounting, but the P/E is at least double its historical average.

When an item advances too far above its mean price, it usually corrects by falling below its mean price. If this holds true, then in due time the S&P will fall in half from current levels, and that's a conservative estimate.

Question: What about all these corporate "buy-back" programs. Aren't they going to help the market in that they will boost the price of the given stocks?

Answer: In my opinion, corporate buy-backs are just blatant attempts to boost or hold up the price of a company's stock. This worked to some extent during the bull market, but it's a stupid and even dangerous process during a bear market. In a bear market cash reserves should be built up, since business will probably contract and many companies will be squeezed for cash as the bear market moves along.

Furthermore, most of the stocks bought in buy-backs are now, or will be, cheaper as the bear market develops. Thus corporations have wasted money buying back their own stock at prices that are probably above the current market price.

Question: What's the best policy of investing or handling your assets during a primary bear market?

Answer: The best policy is to move to the sidelines. I advocate a mixture of T-bills, T-notes and some longer-term T-bonds. For those in high-tax states, I recommend top-grade municipal bonds.

Question: I keep hearing about all the billions of dollars sitting on the sidelines and ready to come in and buy this market. Isn't all that sideline money a good argument in favor of higher prices?

Answer: I've been hearing about the money on the sidelines during every bull and bear market since the 1950s. I'll let you in on a secret – **there's always money on the sidelines – in bull and in bear markets.** In the depths of the Great Depression there was "money on the sidelines."

You want proof? In July of 1932, with the Dow selling at a price of 41 following the worst percentage wipe out of market wealth in history, there was money on the sidelines. All you have to do is look at volume right after the July lows. Volume exploded as the market turned higher.

Big money is always on the sidelines. Big money is always ready to buy the market – when values are right and when the time is right.

INVESTMENT POSITION:

I've been stressing the need for INCOME for over a year. As I see it, that need is going to be critical as this bear market moves on. The growing army of the unemployed will need income. The army of the retired need income, and many of the retirees depend on the income from their fixed income investments.

But the Fed has been pushing rates down, and this has hurt the retirees badly. Where do they get income now, with short rates having collapsed and rates on bonds also heading lower? Then we have the army of stockholders, and they've been taking a beating – no capital gains and no dividends on the stocks they hold.

On top of everything else, instead of savings Americans have debt, carloads of it. This whole situation is slowly but surely developing into a mess. It will result in declining sales by consumers and a panic for income, income from any source, all in an investment world where there is no income. The Fed thinks it's building liquidity for business but what they're doing is killing sources of income for the American people.

I've been telling my subscribers to buy bonds for income. I don't know how many of you have done that, but it's tougher now because it's harder to find good bonds. Short rates have collapsed, so for income you now have to go out further. Where should you have your money now. I still say – bonds.

The danger in holding long bonds is, of course, the potential ravages of inflation. A bond-holder will always get his money back on high-quality bonds, but by the time he gets his money back the purchasing power of his money may have deteriorated.

So buying a long-maturity bond has a risk, and the main risk is usually inflation. The best strategy for the bond buyers is to

reinvest the return and continue to compound. If this is done faithfully, then the power of compounding is so strong that it can take care of any loss due to inflation. But the catch is that you must reinvest – you must follow the compounding principle.

Let's say you are buying tax-free bonds yielding 5%. If inflation is 5% and you continue to reinvest, then theoretically you can build assets, but again you must follow the compounding principle. Besides, if inflation climbs to 5% the odds are that your original bonds will be lower in price but new bonds that you buy will have higher coupons.

In general, a bond buyer should have a program in mind when buying bonds. Of course, by the same token an investor should have a strategy when buying stocks, and that strategy should be closely tied in with Dow Theory.

GLASSMAN: The following is an excerpt from a piece written in the *International Herald Tribune.* In it James Glassman put forth an investment strategy that is now widely accepted.

"The way to make money in stocks is to build a strong, diversified portfolio and hold on to it, through good times and bad. Selling into a downturn is not worth the effort if your time horizon is five years or more. If you dump your shares in GE, how are you going to know when to buy it back?

"Imagine a baby girl born at the end of September, 1929. Her parents want to set up an investment account for her, not to be touched until she is 71. They plan to put the money into a broad-based portfolio like the S&P 500. Imagine that the family friend is a prophet with perfect knowledge of the major events, but not stock prices, for the next three-quarters of a century.

"Are you sure you want to invest $10,000 in the stock market?" the stock prophet warns the couple. "Here's what is going to happen in the decades ahead. There will be a terrible market crash and a Great Depression that will last ten years, then a World War in which millions die, a Cold War, wars in Korea, Vietnam and the Gulf, runaway inflation, at least three oil crises, etc. Wouldn't you rather put your $10,000 under the mattress or at least into some nice Treasury bonds?

"If the mom and dad rejected the offer, they would have done their daughter a huge favor. From September, 1929 (the month before the great crash) to the end of last year, the $10,000 invested in the S&P would have grown to $9,270,000. The same $10,000 would have grown to just $423,000 in long-term Treasury bonds, and to only $145,000 in T-bills."

Russell Comment: So what's wrong with that picture? Nothing if you are really to make the following assumptions. (1) That history will repeat, and that US growth will continue generally higher for the next 71 years, and (2) that you will have the stomach and the psychological strength to watch your portfolio lose a large portion of its value while you wait for the "inevitable" growth and new highs in the averages.

I might add that historically, half of the increase in total return since 1929 has come from reinvested stock dividends. But dividend yield today is less than 2%. This will hamper total return.

Second, I don't know whether Glassman has ever sat through a bear market. Believe me, it's blood-curdling when you sit and watch your assets sink 30%, 40% 50%. From 1929 to 1932 the Dow lost 89% of its value. Would Glassman have the guts to sit through that kind of decline? And if he did sit through it, would it be worth it on his nerves and his health?

Third, Glassman acts as if it makes no difference when you take your position in stocks. But it does. It's one thing if you buy your stocks at the top of a bull market and quite another if you buy your stocks at or near the bottom of a bear market.

The fellow who bought his portfolio in 1932 never saw his stocks go lower. The fellow who bought his portfolio in 1929 had to wait 25 years to break even. Glassman leaves out the psychological element of investing. That's one huge, crucial item to leave out.

It's like the person who is playing poker with a friend for points. He's a winner. He can do no wrong. Then the same guy goes to Vegas and plays for money. He freezes. He's lost his ability to think. In two hours he's wiped out, and he swears he'll never gamble again. There's a huge difference

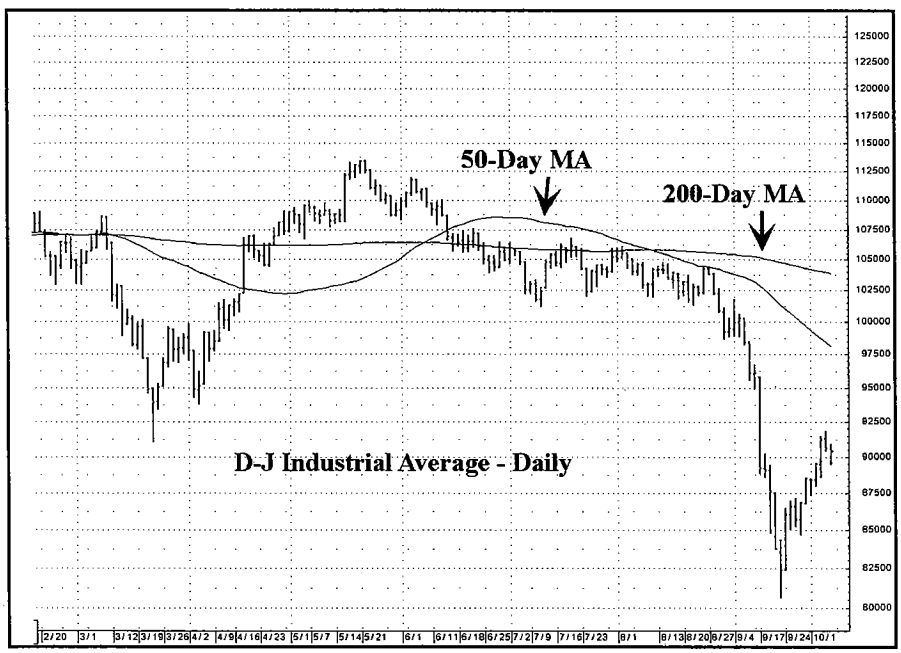
believe me, between the talk and the walk.

LATE NOTES: I'm showing a weekly chart of gold going back to September of 1999. It appears that gold has formed a large and impressive base, actually in the form of a "head-and-shoulders" bottom. Whether gold is poised to break out on the upside remains to be seen, but one thing is certain – the base is there.

To my mind, gold is intrinsically cheap. The Dow at around 8800 buys over thirty ounces of gold. Back in 1980 at the peak of the gold market the Dow would buy one ounce of gold.

Let me put it this way – the potential is there. The Fed has now flooded the markets with liquidity. Contrary opinion favors gold, and by that I mean that almost everybody has written gold off as a relic, a has-been.

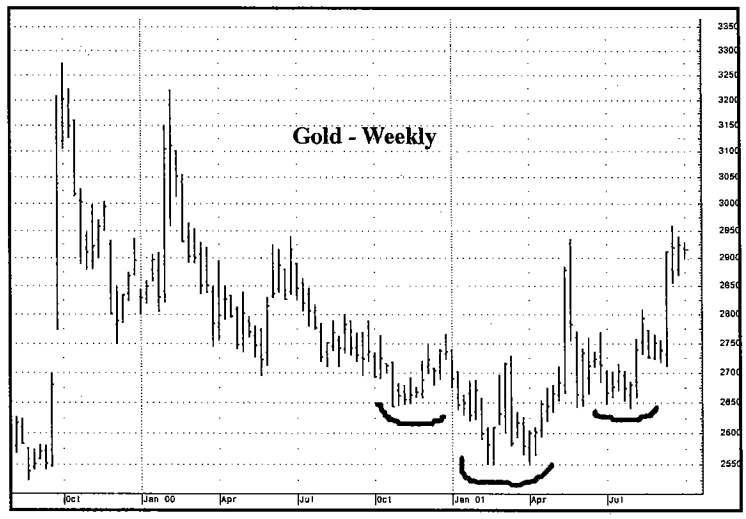
I think the psychological upside barrier to gold is 300.



Above 300 and we could see some action. How to play a potential gold move? Probably buy February 300 gold calls, or even the 320s.

DOW: I also include a daily chart of the Dow along with its 50-day and 200-day moving averages. This chart provides good perspective for what's happened over the last year and what the most recent rally off the September 21 low looks like.

Following the semi-crash which began in August and ended at 8235 for the Dow on September 21, I wrote that the expected automatic recovery following a crash is for the Dow



to recoup half of the points lost on the crash. This would take the Dow back to roughly 9300.

So far, instead of 50% the Dow has recovered 41% of the ground lost in the crash. This is a sub-par recovery, but it may be "all there is." We should know shortly.

I think the consensus thinking is that the market made an important low on September 21. The latest *Merrill Lynch View* mailing that I have just received is headlined, "Forming a Bottom." I'm not so sure. The Lowry's Selling Pressure index has hardly backed off from its recent high.

As a rule, once an important bottom has been put in, Lowry's Selling Pressure Index plunges. The continuing high level of the Selling Pressure Index indicates that the sellers are not satisfied with the current levels. The implication is that September 21 was not the true bottom of this leg of the bear market. The rally off September 21 was mostly a short-covering rally in a continuing bear market.

NEXT MAILING: October 31, 2001, and we are again mailing this Letter to all subscribers. The 9/11 disaster has slowed the return mail and we have yet to process all of the "mail", "don't mail" requests.